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Reform of the International Monetary System

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COMMENT

REFORM OF THE INTERNATIONAL MONETARY SYSTEM

> [T]he perpetual tragedy of history is that things are perpetually being done ten or twenty years too late.[1]

Twenty-six years after the Bretton Woods Agreement founded the International Monetary Fund,[2] the Board of Governors adopted Resolution Number 26-9, dated October 1, 1971.[3] Citing the ". . . dangers of instability and disorder in currency and trade relationships . . ."[4] and declaring that it is of the utmost importance ". . . to avoid the aforesaid dangers and assure continuance of the progress made in national and international wellbeing in the past quarter of a century . . ."[5] the Board of Governors requested the Executive Directors:

> (a) . . . to make reports to the Board of Governors without delay on the measures that are necessary or desirable for the improvement or reform of the international monetary system; and
> (b) for the purpose of (a), to study all aspects of the international monetary system, including the role of reserve currencies, gold and special drawing rights, convertibility, the provisions of the Articles with respect to exchange rates, and the problems caused by distabilizing capital movements; . . .[6]

In response to this request, the Executive Directors of the International Monetary Fund submitted, on August 18, 1972, a preliminary report on "Reform of the International Monetary System".[7]

I
BACKGROUND TO THE REPORT

A. The Present International Monetary System[8]

The cornerstone of the international monetary system as it has existed since the close of World War II is the International Monetary Fund

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1. Meier, *The Bretton Woods Agreement—Twenty-five Years After*, 23 Stan. L. Rev. 235, 275 (1971), quoting from L. Woolf, Downhill All the Way 225 (1968).
2. Articles of Agreement of the International Monetary Fund, Dec. 27, 1945, 60 Stat. 1401 (1946), T.I.A.S. No. 1501, 2 U.N.T.S. 39, *amended* [1968] 20 U.S.T. 2775, T.I.A.S. No. 6748 (approved May 31, 1968; entered into force July 28, 1969) [hereinafter cited as IMF Articles]. *See also* IMF, Articles of Agreement of the International Monetary Fund (1945).
3. IMF, Summary Proceedings Annual Meeting 1971, 331.
4. *Id.*
5. *Id.*
6. *Id.* at 332.
7. IMF, *Reform of the International Monetary System: A Report by the Executive Directors to the Board of Governors* (1972) [hereinafter cited as *Report on Reform*].
8. The following sources may be useful as a glossary for those unfamiliar with the

(IMF). With a current membership of 120 nations,[9] the IMF is a permanent international organization whose purpose is to promote international monetary cooperation and to aid in the growth of international trade and development.[10] The decision-making responsibility of the IMF is placed in the hands of the Board of Governors, on which all member-nations are represented. In practice the day-to-day operations are conducted by the Executive Directors, assisted by a highly qualified staff of about six hundred international civil servants.[11]

To avoid repetition of the restrictive trade policies and competitive devaluations which characterized world trade during the inter-war period,[12] and at the same time to achieve its stated goals, the IMF Articles of Agreement have provided a framework for international monetary

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"trade language" of the present international monetary system: F. MACHLUP, REMAKING THE INTERNATIONAL MONETARY SYSTEM (1968), which is an excellent source on the terminology involving SDR's; D. SNIDER, INTRODUCTION TO INTERNATIONAL ECONOMICS (1967); B. TEW, INTERNATIONAL MONETARY COOPERATION (8th ed., 1965), which is particularly valuable for its discussion of basic principles; R. TRIFFIN, THE EVOLUTION OF THE INTERNATIONAL MONETARY SYSTEM (1964), presenting a thorough account of "adjustment"; R. TRIFFIN, GOLD AND THE DOLLAR CRISIS (1960), which presents a thorough consideration of convertibility and several exchange rate mechanisms.

9. *Recent Activity-Fund*, 9 FINANCE AND DEVELOPMENT 71, 74 (Mar. 1972).

10. IMF Articles *supra* note 2, Art. I. This Article states that the purposes of the IMF are:

(i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.

(ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and to the development of the productive resources of all members as primary objectives of economic policy.

(iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

(iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

(v) To give confidence to members by making the Fund's resources temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

(vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balance of payments of members.

11. M. MENDELSOHN, THE IMF AT WORK 3 (undated), reprinted from AMERICAN BANKER (Apr. 20, Apr. 28, 1971); Art. XII, § 2 (b) permits the Board of Governors to delegate any of its powers to the Executive Directors with the specific exception, among other things, of power to admit new members, revise quotas, initiate uniform par-value changes, or revise repurchase rules. Art. XXVII (a) permits the same delegation with respect to SDR's except, among other things, the power to allocate or cancel SDR's, and the conditions of holding and use of SDR's. IMF Articles, *supra* note 2.

12. Competitive devaluations and trade restrictions had this effect during the interwar period, when world trade decreased from $55.9 billion in 1929 to $21.8 billion in 1932. Note, *Legal Problems of International Monetary Reform*, 20 STAN. L. REV. 870, 875 n.4 (1968) [hereinafter cited as *Legal Problems*].

cooperation within which world trade has flourished for over a quarter of a century.[13]

1. Stability of Exchange Rates and Convertibility

The basis of the IMF framework is the establishment of stable exchange rates operating through a mechanism which may be called the "adjustable peg" system.[14]

In such a system, exchange rates between nations are fixed at a level expressed in terms of gold or United States dollars.[15] The relation of one currency to gold is referred to as "par-value," while the relation of one currency to another is referred to as "parity."[16] Member-nations are required to maintain their prescribed parity through free exchange markets by buying or selling foreign currencies at the parity level.[17] This obligation may also be satisfied by the free purchase or sale of gold at the established par-value, although the United States is the only member-nation which has opted to defend parity in this way.[18]

Member-nations may not change their par-value beyond the permitted margin except to correct a "fundamental disequilibrium."[19] When such a situation arises, nations may make the proposed change only with IMF approval.[20] The IMF, however, is without power to initiate such changes itself; its role is essentially passive in this respect.

Through this mechanism, the exchange rate is "pegged." It is "adjustable," however, by virtue of the "fundamental disequilibrium" clause. Convertibility, *i.e.*, the ability to exchange one currency for another, is also provided for in the IMF Articles.[21] There are presently thirty-five nations which have accepted this obligation, including the United States

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13. Between 1950 and 1962, for example, world trade grew from approximately $54 billion to $116 billion. *Id.* at 888. Dollar-value measurements may be deceptive, however, due to increasing world-wide inflation. *See, e.g.*, IMF, 1971 ANNUAL REPORT 7.
14. *See, e.g.*, SNIDER, *supra* note 8, at 340 *et seq*.
15. IMF Articles, *supra* note 2, Art. IV, § 1(a).
16. This definition is that adopted by the Executive Directors. *Report on Reform*, *supra* note 7, at 12 n.1.
17. IMF Articles, *supra* note 2, Art. IV, § 4(b).
18. Meier, *supra* note 1, at 248. This option was made available to all member-nations under the terms of Art. IV, § 4(b).
19. IMF Articles, *supra* note 2, Art. IV, § 5(a). The Articles do not define the term "fundamental disequilibrium." but it can be taken to mean ". . . a persistent balance of payments disequilibrium . . . not amenable to correction at prevailing exchange rates except through controls over current transactions or at the cost of serious unemployment or inflation." SNIDER, *supra* note 8, at 345.
20. IMF Articles, *supra* note 2, Art. IV, § 5(b).
21. IMF Articles, *supra* note 2, Art. VIII, §§ 2, 3, 4.

and most of Western Europe.[22] The remainder have chosen the modified convertibility status provided for under the Articles, although such status is only temporary.[23]

2. Reserves and Balance of Payments

For such a system to function, in addition to a convertibility requirement nations must, even when in deficit, have an adequate supply of reserves on hand in order to meet their obligations. The IMF provides the necessary supply of reserves by extending credit to member-nations. The resources necessary to extend this credit are acquired through the subscriptions of member-nations. Upon joining the IMF, each nation is assigned a quota, twenty-five per cent of which is payable in gold and the remainder in the member's currency.[24] A member-nation, finding itself temporarily in a balance of payments deficit, may borrow the reserves it needs from the IMF resources by means of its "drawing rights."[25]

Drawing rights initially appear to be a simple purchase operation. A member-nation in need of foreign currency turns over to the IMF an amount of its own currency equivalent to the amount of foreign exchange it needs to finance a deficit. In effect, it buys from the IMF pool the necessary foreign currency at the prevailing exchange rate. The transaction is actually a credit operation, however, in view of the following requirements and restrictions placed upon the drawing member-nation.

First, the member is required to repurchase the amount of his currency used to buy foreign currency from the IMF pool.[26] This may be accomplished either with the same foreign exchange borrowed originally, or with a mixture of other currencies, the stocks of which the IMF may find depleted through other drawings and in need of being replenished. In either case, the method of repayment is left to the discretion of the IMF.[27]

Second, limits are placed on the amount a member-nation may draw from the IMF. A drawing nation may not draw foreign exchange from

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22. MENDELSOHN, *supra* note 11, at 6.
23. IMF Articles, *supra* note 2, Art. XIV; *see also* MENDELSOHN, *supra* note 11, at 6.
24. IMF Articles, *supra* note 2, Art. III. A quota of $100 million thus requires a payment to the IMF of $25 million in gold and $75 million in the member-nation's currency; it is thus easy to understand why the first 25 per cent of a member's drawings are automatic and are referred to as the "gold tranche."
25. An excellent explanation of the operations of IMF drawing rights is presented by MENDELSOHN, *supra* note 11, at 7-8.
26. IMF Articles, *supra* note 2, Art. V, § 7.
27. IMF Articles, *supra* note 2, Art. V, § 7(b).

the IMF if it would cause IMF holdings of the drawing nation's currency to increase by more than twenty-five per cent over any twelve month period, or to exceed the nation's quota by over two hundred per cent.[28]

Finally, although a member-nation has automatic drawing rights of up to twenty-five per cent of its quota[29]—the so-called "gold tranche"—drawings beyond that will be subject to increasingly close scrutiny by the IMF on the basis of the member's balance of payments situation and the member-nation's own attempts to restore equilibrium.

These factors also point out one other major aspect of the present international monetary system as embodied by the IMF. The framework attempts basically to deal with, and is predominantly concerned with, short-term balance of payments deficits.[30] Although the IMF will aid in financing such a deficit, a long-term balance of payments deficit is the responsibility of the individual member. The attitude is that such a situation should be cured by the national monetary authorities through domestic fiscal and monetary policies.

B. The Problems within the Present International Monetary System

1. The Position of the United States Dollar

The position of the dollar in the present international monetary system, and within the framework of the IMF, is that of a "key currency,"[31] because as Professor Gerald Meier points out, ". . . the United States is now the sole country that pegs its currency to gold, [while] other countries have pegged their currencies in relation to the dollar."[32] Consequently, the dollar is characterized by two functions it performs as an international currency: first, as the primary intervention currency,[33] *i.e.*, that nations, in order to meet their obligation of maintaining parity within the prescribed margin, will intervene in their exchange markets primarily with dollars rather than with gold or other currencies; second, as the primary reserve currency.[34] While other currencies were freely

28. IMF Articles, *supra* note 2, Art. V, § 3.
29. IMF Articles, *supra* note 2, Art. V, § 3(d).
30. Snider, *supra* note 8, at 344.
31. Meier, *supra* note 1, at 248.
32. *Id.*; *see also* note 18 *supra* and accompanying text.
33. *Id.* at 249.
34. *Id.*

convertible into dollars, dollars were freely convertible into gold. For this reason nations accepted dollars as payment of deficits or other obligations. In addition, while dollars were freely convertible and were thus as "good as gold," they, unlike gold, could earn interest, and, as the supply of dollars increased through interest or through United States deficits, the amount of international reserves increased. These factors combined to induce monetary authorities to hold surplus dollars in reserve to back-up their own currencies and finance their own deficits rather than convert them, as would be done with the surplus holdings of other currencies.

2. Results of the Dollar's Position

The practice of holding United States dollars as a reserve asset has several effects upon both the United States and other IMF member-nations.

First, there is some loss of internal control over the exchange rate. As nations continue to hold dollars as reserve assets, and as the supply of dollars increases world-wide, world reserves continue to grow. In fact, the increased supply of dollars accounts for nearly half of the increase in world-wide reserves since 1950.[35] It is thus considered generally undesirable for the United States to devalue the par-value of the dollar; such an act would decrease world reserves.[36] In addition, a devaluation of the dollar might entail a chain reaction of devaluation of the par-values of other currencies, as all currencies are, by agreement, pegged to the dollar.

Second, the value of the dollar as a reserve asset and the facility with which it may be used as the major intervention currency tend to discour-

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35. "Reserves held in the form of gold actually declined over the years 1964-1969. More than half the increase of reserves in the period was due to drawings . . . from the Fund; these involve an increase in repayment commitments by the countries making the drawings, and do not constitute a long-term addition to net world reserves. The increased holdings of dollar balances constituted the other major source of reserve holdings." While world reserves increased in total from $48.8 billion in 1950 to $76.3 billion in 1968, the amount of officially held dollars rose from $4.9 billion to $17.5 billion over the same period. Meier, *supra* note 1, at 249 nn. 49 & 50.

36. An 8.57 percent devaluation of the dollar has already occurred as a result of the Smithsonian Agreements of December, 1971. *The New Exchange Rates*, 122 THE BANKER 10, 11 (Mar. 1972). This was a controlled devaluation, however, the result of international agreement and not a unilateral action by the United States made with IMF approval. "New strains are . . . bound to show themselves as soon as a major change occurs in the economic situation compared with that at the time of the [Smithsonian] discussions, which is generally expected for the second half of 1972 . . . and at the latest in the first half of 1973." Kleps, *On the Way to the Next Monetary Crisis*, 4 INTERECONOMICS 107, 109 (Apr. 1972).

age official holders of dollars from converting them into gold. As the United States would convert gold held only by official holders, the convertibility of the dollar and the maintenance of its par-value was rarely put to the test. The United States also maintained its parity by freely buying and selling gold, in accordance with the IMF Agreement. Since defense of the dollar's parity is accomplished in the same way as defense of the dollar's par-value, the United States is not often called upon to maintain parity. Other nations, however, do not enjoy the same status. Their parity is pegged to the dollar, and their par-value is expressed in terms of gold or dollars. Thus, in maintaining their own parity they indirectly maintain the par-value and parity of the dollar. For example, private holders of dollars wishing to speculate could not demand conversion into gold from the United States. They could, however, obtain conversion into other currencies from nations whose currency is convertible by selling dollars on the exchange markets. Were the demand for other currencies to become so great as to threaten existing parity, nations would be required to intervene with their reserves to defend their exchange rates. Thus, member-nations other than the United States would in effect be defending the value of the dollar.

A final result of the position of the dollar as a reserve currency is that it enables the United States to avoid using its assets to meet its balance of payments deficits. To the United States the dollar is a domestic currency; to the member-nations, however, it is a reserve asset, and as such it is freely acceptable to most nations. Thus, the United States can purchase imports with its domestic currency without resort to exchange market transactions, while at the same time it will have little fear that its gold reserves will be drained through conversion of these dollars. If the United States operates in an over-all balance of payments deficit, it may finance this deficit through the simple expedient of printing more dollars and transferring them to the appropriate nation's account. Of course, unless United States gold reserves increase along with the amount of dollars, the amount of liabilities will soon become greater than the assets available. In addition, as the supply of dollars increases, the confidence in the ability of the United States to convert decreases, thereby weakening the entire monetary system.[37] Were this to happen, member-

37. It was partially to forestall such a situation that the United States ceased converting gold in August, 1971. This has not solved the problem, but only put it off. If the United States is to meet IMF obligations, it must at some time reinitiate dollar con-

nations could refuse to accept more dollars as payment. This would not be in their own interest because if the deficit grew sufficiently large, the foreign exchange reserves of the United States combined with its drawing rights in the IMF might be unable to meet the amount of liabilities the United States was required to convert. The United States would then be forced to draw upon its gold reserves to meet the demand, resulting in a diminishing amount of reserves to support its outstanding currency. The structure would collapse like a house of cards if other nations, fearing to be the last to cash in on dwindling United States reserves, followed suit. An entire disintegration of the international monetary system could result.

3. Past Attempts at Reform

The International Monetary Fund attempted to ease these problems in 1968 with the introduction of Special Drawing Rights (SDR).[38] SDR's are an artificially created reserve asset allocated to member-nations who wish to participate. Allocation of SDR's is in proportion to each member-nation's quota, and they are characterized by an obligation on the part of all participating member-nations to freely accept them up to twice each nation's net cumulative allocation.[39] SDR transactions are normally accomplished through the "designation" mechanism.[40] A country wishing to use its SDR's to obtain foreign exchange necessary for its balance of payments or for reserves will simply inform the IMF. The IMF in turn will designate one or more participating member-nations, usually those in surplus, to accept the SDR's and provide the desired foreign exchange.[41]

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vertibility. One aim of a reformed system is to enable this without a corresponding "run" on the dollar.

38. IMF Articles, *supra* note 2, Arts. XXI to XXXII. The Executive Directors point out that, "[t]he first decision to allocate SDR's was predicated on the assumption that the earlier process of reserve creation had substantially come to an end. The magnitude of the reserve creation in the form of reserve currencies in 1970 and 1971 showed, however, that no mechanism existed to ensure that the external deficit of the United States and the accumulation of dollars would diminish. Indeed, both assumed unprecedented proportions in 1970 and 1971 under the influence of exchange rate misalignment and massive capital outflows." *Report on Reform, supra* note 7, at 6.

39. IMF Articles, *supra* note 2, Art. XXV, § 4.

"A participant's net cumulative allocation is the total of special drawing rights allocated to it minus the special drawing rights allocated to it that have been cancelled. If there are no cancellations, net cumulative allocations will be simply the total number of units allocated to each participant." Gold, *A Comparison of Special Drawing Rights and Gold As Reserve Assets*, 2 L. & POL. INT'L BUS. 326, 342 (1970).

40. IMF Articles, *supra* note 2, Art. XXV, § 5.

41. "The is a legal obligation on the country designated not only to supply foreign exchange for SDR's, but to supply one of eight currencies classified by the Fund as 'convertible in fact': the U.S. dollar, British sterling and French franc in the first category—being convertible into each other—and the Belgian franc, German mark, Italian

The most important point about SDR's is that they permit nations to build up reserves of foreign exchange without any other nation going into deficit. Although they approach a form of reserve creation, SDR's are essentially a method of temporarily accumulating foreign exchange reserves. In effect, the purpose they serve is to increase the drawing rights of members through an increase in quotas without the corresponding requirement of allotting to the IMF twenty-five per cent of the quota increase in gold. Further, SDR's do not require any currency payment on the part of the drawing nation as in the case of normal drawing rights. Participating member-nations are thereby able to accumulate foreign exchange when necessary without any drain on their existing reserve assets. The obligation to "reconstitute"[42] SDR's, however, points out the fact that SDR's are not an entirely obligation-free form of reserves. Although nations are free to use their entire allocations of SDR's, reconstitution requires over time the maintenance of a minimum average balance of SDR's. Present requirements are that a member's average SDR balance over five years does not fall below thirty per cent of its net cumulative allocation. In this sense, SDR's are merely a form of credit extended to participating nations; careful use of SDR's by the participants, however, avoids the reconstitution requirement and makes SDR's more in the nature of created reserves.

The basic reform idea behind SDR's was that they would offer participating member-nations an alternative to dollar holdings for reserve purposes. Although widely used, SDR's have failed to accomplish this goal. Dollar holdings have continued to mushroom, and the problems associated with such holdings have worsened.[43]

II
THE APPROACH AND IMPACT OF THE REPORT TO THE PROBLEMS OF THE INTERNATIONAL MONETARY SYSTEM

The Executive Directors in their Report have taken a fresh approach to the problems facing the international monetary system and are in the

lire, the Netherlands guilder and Mexican peso in the second category—being convertible directly into U.S. dollars only." MENDELSOHN, *supra* note 11, at 8.

42. IMF Articles, *supra* note 2, Art. XXV, § 6.

43. SDR's have not "failed" in any sense. Rather, they were introduced into the international monetary system at a time when various factors united to cause an unprecedented increase in world reserves, particularly in the form of foreign exchange. The vast increases of foreign exchange holdings have minimized the impact SDR's might otherwise have had on dollar holdings. The various factors causing this increase are discussed in IMF, 1971 ANNUAL REPORT, 21-32.

process of formulating a comprehensive scheme aimed at a solution to all of the causes of the present difficulties.[44]

The Directors recognize that their Report is ". . . necessarily preliminary in character . . ."[45] due to the difficulty of foreseeing which possible course for development of the international monetary system ". . . would best accomodate the diverse positions and interests of member countries, while safeguarding the global character of the system and minimizing the risk of any retreat into protectionism and inward-looking blocks."[46] They declare, however, that there has been much progress in identifying and examining major issues for further study in negotiation.[47]

The Directors clearly recognize that the basic problems stem from the large imbalance of trade and payments. More specifically, they consider several factors which have seriously impeded the operation of the system in the achievement of its stated goals; these are: 1) the inflexibility of the exchange rates of members, a problem common to all IMF member-nations but which has recently arisen ". . . in acute form in the case of the U.S. dollar . . .";[48] 2) the lack of a reserve asset (*e.g.*, gold or currency) which is sufficiently liquid to accommodate the rapidly fluctuating demands of modern world trade and finance; and 3) the protectionist domestic policies of member-nations.[49]

Approaching these problems within the context of the stated goals of the IMF as expressed in its Articles of Agreement, the Directors state:

> In general terms, the avoidance or elimination of the difficulties that impeded the system in the past and the achievement of the aims mentioned . . . *will depend on the adoption of improved arrangements for the adjustment and settlement of payments imbalances.* The essence of an efficient adjustment

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44. "The elements of the international monetary system that are considered in these separate chapters are closely interrelated. Thus, for example, decisions relating to any new arrangements for the settlement of payments imbalances would depend heavily on the working . . . of the adjustment process, in particular the exchange rate mechanism. Similarly a system involving greater exchange rate flexibility for all currencies . . . might tend to both diminish the need for reserves and the role of reserve currencies. The future role of reserve currencies, together with other reserve assets, would also to some extent be determined by any settlement arrangements that were adopted." *Id.* at 2.

45. *Id.* at 11.

46. *Id.*

47. The *Report on Reform, supra* note 7, is divided into six chapters. After discussing the need for reform in Chapter 1, the Directors address the specific difficulties of the exchange rate mechanism (Chapter II), convertibility and settlement of imbalances (Chapter III), and the roles of various assets in reserves (Chapter IV). It is on these aspects of the Report that this comment focuses. The two remaining chapters of the Report, dealing with the problems of disequilibrating capital movements, in Chapter V, and reform and the developing countries, in Chapter VI, are not discussed here.

48. *Id.* at 5.

49. It is these policies which, the Directors state, ". . . [have] made balance of payments adjustment more difficult." *Id.* at 6.

> mechanism is that countries *refrain from policies that are likely to lead to severe balance of payments disequilibria and take early action to correct such disequilibria as nevertheless occur.* . . . Attempts should also be made to find *clearer criteria for allocating responsibilities for initiating adjustment* among countries in different balance of payment situations. In addition, *settlement arrangements for all countries* should be such as to promote the objective of the adjustment process.[50]

This summary is essential background to an understanding of the Directors' endorsement or rejection of various alternatives for dealing with each of the principal problems in international monetary reform.

A. The Exchange Rate Mechanism

"The exchange rate mechanism plays a major role in the adjustment process, and the unsatisfactory functioning of this mechanism was an important factor in the weakness of the process. . . ."[51] This mechanism has recently been the subject of a great amount of analysis, and several reform proposals have come to the fore.[52] In 1970 the Executive Directors submitted a report entitled "The Role of Exchange Rates in the Adjustment of International Payments."[53] In that report the Directors extensively reviewed the exchange rate mechanism, with particular attention devoted to current proposals. The conclusion of the 1970 report was:

> . . . that the par value system was the most appropriate general exchange rate regime but that acceptance of this conclusion carried with it an obligation on all parties to make the system as effective as possible. . . . The Executive Directors suggested that, in certain cases, prompter and smaller adjustments in members' par values would help to avoid the building up of large disequilibria and the eventual recourse to larger adjustments.[54]

Thus, the Directors merely called for more cooperation within the already-existing framework.

The experience of 1970 is not the experience of 1972, however, and basic attitudes have altered. The developments since 1970 have injected new elements into discussion and evaluation of the exchange rate mechanism.[55]

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50. *Id.* at 8 (emphasis added).
51. *Id.* at 11.
52. *See, e.g., Legal Problems, supra* note 12; Meier, *supra* note 1. For a review of various reform plans, *see* F. Machlup, Plans for Reform of the International Monetary System (1964).
53. IMF, *The Role of Exchange Rates in the Adjustment of International Payments: A Report by the Executive Directors* (1970) [hereinafter cited as *1970 Report*]; *see also* Polasek, *The Role of Exchange Rates In International Adjustment: the IMF Report and Beyond*, 47 Econ. Rec. 338 (1971).
54. *Report on Reform, supra* note 7, at 11.
55. "The widespread recourse to floating rates after August 1971 showed that . . . the

In the face of the difficulties in the present system, the Directors now call for a ". . . fresh approach . . . which will accord to the United States, as well as to other nations, a *due measure of initiative* in the effective exercise of exchange rate flexibility."[56] The Directors now accept that "[s]ince . . . the exchange rate of each currency is—to a larger or smaller extent—a matter of concern to all members, it is *unavoidable* that some judgment as to appropriate rates be made by the *international community* in accordance with the best techniques available."[57]

1. The "Crawling Peg" Method

One of the modifications considered in the 1970 Report was the "crawling peg"[58] method of adjustment. Under this proposal exchange rates would, on the whole, remain stable, with adjustments made in small automatic steps according to a predetermined formula. The formula would be geared to objective criteria, such as shifts in the amount of a member-state's official reserves, changes in the spot of exchange of a member-state's currency, or, even, changes in relative price indices between different countries. These objective criteria, taken either together or separately, would indicate when adjustment would be necessary, and how large it should be. The adjustment itself might be discretionary with the member-nation or could even be provided for automatically through the IMF.[59]

The "crawling peg," its proponents argue, would provide both the desired stability and flexibility in exchange rates. The objections noted by the 1970 Report were that objective indicators may reflect only short-term features of the balance of payments, rather than the development of underlying structural disequilibria; restrictive domestic monetary policies

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system as previously operated was subject to pressures beyond its power to handle, and underlines the urgency of making it less crisis prone. Two inferences may be drawn from this experience. First, protracted uncertainties about future exchange rate relationships may unfavorably affect the general economic climate. . . . Second, floating rates (like fixed rates) require some means of reconciling countries' interests and avoiding conflicting policies, and it is virtually impossible to negotiate the necessary arrangements at short notice under the impact of sudden shocks to the system." *Id.*; *see also* note 80 *infra*.

56. *Id.* at 12 (emphasis added).

57. *Id.* at 14 (emphasis added).

58. For a discussion of the advantages and disadvantages of this mechanism, *see* Bach, *Problems of the International Monetary System and Proposals for Reform—1944-1970*, 51 FED. RES. ST. LOUIS 24 (1972).

59. *Id.* at 30-31. Recall that the IMF does not presently have such power; par-value changes are made only upon a member-nation's request, which will be granted only if that member suffers "fundamental disequilibrium." *See* notes 19 & 20 *supra* and accompanying text.

of members might prevent such disequilibria from being reflected in the relevant data.[60]

Now, however, the Directors suggest that, in light of the additional experience gained by the IMF in guiding exchange rate adjustment in recent years, it may be possible to establish objective criteria to provide a continuous and accurate review of exchange rates.[61] Thus, any reformed monetary system is likely to incorporate the major features of the "crawling peg" system. Such a mechanism provides for an allocation of responsibility between member-nations and the IMF, and allows for a due measure of initiative for change resting with individual members.

This would expand the present role of the IMF as consultant and coordinator for member-nations on international monetary policy; the IMF would hold some power, power to bring about necessary changes in exchange rates.[62] Pointing out that the persent Articles of the IMF are inadequate to meet this purpose,[63] the Directors also recognize that levying any form of sanctions against recalcitrant members is an extremely complex issue. Notwithstanding the obstacles,[64] the Report asserts that ". . . the importance to the system of having at its disposal some form

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60. *See* Polasek, *supra* note 53, at 341.

61. The report acknowledges that "[s]ome consider . . . that the influence and initiative of the Fund should continue to be exercised principally through analysis and persuasion. In their view, the initiative of the Fund has to be cautiously exercised and should normally be addressed to the need for balance of payments adjustment, as far as possible leaving the choice of instruments, including proposals for par value changes, to members themselves. . . . [Others] consider that surveillance of exchange rates would work more satisfactorily if it encompassed certain initiatives by the Fund with respect to par value changes that it considered to be required. To some extent there has always been informal activity in this direction, and it may be possible and desirable to extend this practice." *Report on Reform, supra* note 7, at 17.

62. "Ultimately decisive for the effectiveness of the monetary reform is a successive coordination of national economic policies on the foundation of universal monetary discipline. . . ." Kleps, *supra* note 36, at 110.

63. *Report on Reform, supra* note 7, at 18; the Directors are referring to Art. VII, §§ 1 and 3 and Art. XII, § 8, IMF Articles, *supra* note 2.

64. "One question is how definite the rules inscribed in the Articles would have to be, and how precisely the circumstances of their application would have to be delineated, in order to warrant the application of measures or procedures that might be regarded as penalizing a member that had defaulted in performing its obligation or whose balance of payments policies conflicted with criteria that had been internationally agreed. . . . It would also be for consideration whether any such measures or procedures should involve progressively firmer pressures on a member that failed to respond. Other questions that arise are, first, whether members would be willing to take decisions in the Fund . . . to bring pressure to bear on a particular member; second, whether members would be willing to take the action enjoined, or permitted by any decisions that were adopted; and, third, whether it would be desirable or possible to design procedures under which rules, once agreed, could to a large extent apply without the exercise of further discretion." *Report on Reform, supra* note 7, at 18.

of collective leverage is such that the subject deserves study and consideration."[65]

2. Stable Parity with Wider Margins

Another reform proposal considered by the 1970 Report was the recommendation for stable parity with wider margins.[66] Under this plan, the IMF Articles would be modified to allow an exchange rate to vary within, for example, five per cent, on either side of parity, instead of the restrictive one per cent variation now permitted.[67] Unlike a freely-flexible exchange rate proposal,[68] however, wider margins would not render the need for reserves obsolete, because member-nations would still be required to intervene whenever the rates threatened to pass the upper or lower limits of the margin. Such a system would, nevertheless, allow for the minor adjustments in parity necessary to reflect changes in relative costs and prices *vis-à-vis* a nation's principal trading partner. The required intervention at marginal limits to prevent very large changes in parity would, at the same time, ensure the confidence and stability necessary to long-term growth.

Other advantages to this system are: first, increasing the permissible rate fluctuation would facilitate equilibrating short-term capital flows while discouraging disequilibrating flows, assuming continued confidence in the existing parity; second, by reducing the reliability of exchange rates within the wider margins, this system would reduce the sensitivity of short-term capital flows to variations in domestic monetary policy; third, this in turn would inhibit currency speculation.[69]

In the 1970 Report, the Directors set aside this proposal as inconsistent with the par-value system because:

> . . . countries would find their competitive positions subjected to sudden and

65. *Id.*
66. *See, e.g.,* Bach, *supra* note 58.
67. IMF Articles, *supra* note 2, Art. IV, § 3.
68. *See* notes 75-79 *infra* and accompanying text.
69. Short-term capital is mainly currency which flows into a nation for purposes of investment, and is particularly responsive to domestic monetary policies. If, for example, the United States Federal Reserve were to raise domestic interest rates, foreign investors might likely respond by purchasing dollars on the exchange markets for short-term American investment. The more capital thus attracted, the more upward pressure on the exchange rate would result. If the interest rate in the United States were 5 per cent, investors could be assured of a 4 per cent gain less costs because the exchange rate would rise by no more than one per cent under the present system. If exchange rates were permitted to fluctuate to a greater degree, pressure on the rate caused by the investors' demand for dollars might cause a 3 or 4 per cent increase in the exchange rate. Gains in this case would be much lower for investors. In this way, wider margins would "desensitize" short-term capital flows to national monetary policies.

> inappropriate changes as a result of temporary market developments or of administrative actions of other countries through official intervention in exchange markets.[70]

Furthermore, wider margins might prove disadvantageous to the developing nations, which might wish to encourage short-term capital inflows. A system which desensitized such flows might make it difficult for these nations to attract capital through their domestic monetary policies.

The Report adopts a less cautious attitude toward wider margins around parity. Noting that since the Smithsonian Agreements of December 18, 1971,[71] wider margins have been increasingly used on a temporary basis, the Directors state: "It is now for consideration whether wider margins should become a *permanent feature of the par value system* . . . and how wide such margins should be. . . ."[72] Further consideration would be given to the possibility of IMF authorization of wider margins for certain member-nations, while at the same time maintaining narrower margins for others, with power in the IMF to withdraw permission to maintain the designated margin.[73] Thus, it appears likely that the concept of wider margins will be incorporated into a compromise solution providing wider IMF-controlled margins for the industrial nations, and narrower margins for the developing nations.[74]

3. Floating Exchange Rates

A third reform considered in the 1970 Report was the prosposal for freely-fluctuating or floating exchange rates.[75] The adoption of such a

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70. *1970 Report, supra* note 53, at 43.

71. The Smithsonian Agreements are reported in *The New Exchange Rates, supra* note 36; Reierson, *What Happened at Washington,* 122 BANKER 10 (Jan. 1972).

In describing the Smithsonian Agreement the Directors report; ". . . [t]he Executive Directors adopted a decision establishing a temporary regime under which a member might permit the exchange rates for its currency to move within margins of 2¼ per cent on either side of the established relationship of its currency to its intervention currency. The decision also provided that a member that takes appropriate measures to maintain the exchange rates for its currency within the margins of 2¼ per cent in terms of its intervention currency may also permit the resulting exchange rates for its currency in terms of other currencies to fluctuate within margins of not more than 4½ per cent of the relationship based on their relative par values or central rates, with further margins of 1 per cent each way in certain circumstances." *Report on Reform, supra* note 7, at 19.

72. *Id.* at 19 (emphasis added).

73. *Id.* It is also for consideration ". . . whether alternatively, the Fund might be authorized to permit wider margins in certain circumstances whether for currencies generally or in particular cases; and whether any such authority should be exercised on the basis of a decision taken by some specified majority and should include the right to withdraw any permission given under it." *Id.*

74. The Directors point out, however, that they have not ". . . reached a common view as to an appropriate regime of margins which might succeed the present temporary arrangements." *Id.* at 20.

75. *See, e.g.,* R. TRIFFIN, GOLD AND THE DOLLAR CRISIS 82 *et seq.* (1960). For arguments

system would eliminate the need for reserve assets; since exchange rates would be subject solely to the free market forces of supply and demand, there would be no need for government intervention to maintain any particular parity. Market forces would cause the exchange rate to vary until a deficit or surplus were removed.[76] The major argument in favor of a freely-fluctuating exchange rate is that fluctuations would automatically ". . . offset the impact of disparate national policies upon the international pattern of prices and costs . . ."[77] and would in this manner preserve ". . . long run balance in each country's international transactions without recourse to trade or exchange restrictions, and without any interference with each country's freedom to pursue whatever internal monetary and credit policies it chooses."[78]

The *sine qua non* of such a system, however, is a free exchange market, devoid of governmental influence. This is unlikely because of the impact which movements in the rate of exchange have on domestic economies, and the time required for natural adjustment.[79]

The present Report reopens the question of a floating exchange rate in view of the many countries which turned to this solution during the monetary crisis of 1971.[80] Specifically, the Directors note that ". . . the granting of legal authority to the Fund to approve temporary deviation under an express power to approve, subject to conditions, [and to revoke the deviations when no longer necessary] might enable the Fund to deal more effectively with [such situations.]"[81]

B. Convertibility and Settlement of Imbalances

The question of convertibility and the settlement of imbalances refers particularly, although not solely, to the United States. The unique posi-

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strongly in favor of flexible exchange rates, *see* Watts, *The Purpose of Fixed Parities*, 3 EUROMONEY 28 (Dec. 1971); *but see* Bareau, *Back to Bancors*, 3 EUROMONEY 18 (Nov. 1971).

76. *See, e.g.*, SNIDER, *supra* note 8, at 303 *et seq.*

77. TRIFFIN, *supra* note 75.

78. *Id.*

79. In the Directors' words, this proposal was set aside because of the belief that "... national authorities could not be expected in modern conditions to adopt a policy of neutrality with respect to movements in an economic variable of such importance to the domestic economy as the rate of exchange, with its effect on prices, incomes, employment, and the structure of industry as between domestic and foreign sectors." *1970 Report*, *supra* note 53, at 42.

80. Between May 9, 1971, and the Smithsonian Agreements of December 18, 1971, the Canadian dollar, German mark, Belgian franc and Dutch guilder were "floating." Kleps, *supra* note 62, at 107.

81. *Report on Reform*, *supra* note 7, at 21.

tion of the United States dollar in the present international monetary system is one of the major reasons there is need for reform. The problem extends beyond the power of any single nation; proper solution requires an international effort coordinated through the IMF.

As previously noted, the unique position of the United States dollar has had three major effects: 1) diminished control by the United States over its exchange rate; 2) maintenance of the dollar's value by nations other than the United States; and 3) the financing of United States deficits by increasing outstanding dollar liabilities.[82] Compounding these problems is the fact that the competitive trade position of the United States in the world market has deteriorated due to structural changes in worldwide prices and costs.[83] As the United States trade position weakens, the need for exchange adjustment becomes more critical because United States imbalances stem from a fundamental disequilibrium.[84] The rigidity of the present exchange mechanism and the present undesirability of dollar devaluation,[85] however, have combined to resist the necessary adjustment. Thus, the United States faces the prospect of a continuing and growing deficit, which can only lessen confidence in, and attractiveness of, the dollar to its official holders. The result may eventually be a demand for conversion of the dollar which the United States cannot satisfy.[86]

1. The Approach of the Report

Because the difficulties involved with the United States dollar have been partially caused by the problems of the exchange rate mechanism and the stock of reserves, while at the same time partially exacerbating these problems, the Directors take the position that any reform ". . . should differ in some major respects from the position that prevailed with respect to the U.S. dollar prior to August 15, 1971 [when the convertibility of the dollar into gold was suspended]."[87] Although the focus has been on the United States dollar, the Report states that official holdings of sub-

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82. *See* note 37 *supra* and accompanying text.

83. The United States balance of trade—the measure of exports *vis-à-vis* imports—had fallen from a $7.1 billion surplus in 1964 to a $1.4 billion deficit in August, 1971. *What to Expect Next in the World's Money Crisis*, U.S. NEWS AND WORLD REPORT, Oct. 11, 1971, at 89.

84. The Directors state that the system of creating reserve assets at the expense of all parties involved is based on structural imbalances "of a size that could not be maintained by either side." *Report on Reform*, *supra* note 7, at 23.

85. *See* note 34 *supra* and accompanying text.

86. IMF, 1971 ANNUAL REPORT 21-23, 147-48.

87. *Report on Reform*, *supra* note 7, at 23-24.

sidiary reserve currencies may also be substantial, and could lead to similar problems in the future. "Consequently, the question of appropriate convertibility and settlement arrangements arises also with respect to the secondary reserve centers."[88] The Directors also maintain a cautious approach by pointing out that the question of settlement arrangements must be attuned not only to the needs of the reserve centers, but also to the needs and interests of those member-nations which are not reserve centers.[89]

2. *Conditions of Successful Reform*

The Report specifies three conditions precedent to any form of asset settlement: 1) an adequate improvement in the reserve position of the United States, which might come from changes in the balance of payments, SDR allocations, or long-term currency loans from other nations; 2) ". . . a more effective [exchange rate] adjustment mechanism involving all members and [including] a readiness on the part of other members to accept changes in the . . . exchange rate of the U.S. dollar. . . .";[90] and 3) suitable arrangements regarding temporary imbalances, particularly those arising from short-term capital flows.

3. *Proposals for Asset Settlement*

The Directors have, save for a passing reference,[91] assumed that any future reform must necessarily include a plan for asset settlement, and have approached the question of dealing with reserve center nations solely in terms of conditions, timing[92] and methods. Although the methods must satisfy the conditions, the Directors compare each proposed

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88. *Id.* at 23.

89. "Any asset settlement arrangement that was adopted would have to be geared not only to the achievement of the other objectives discussed earlier, but also, as far as possible, to the direct interests of members other than the reserve centers." *Id.* at 26.

90. *Id.* at 25.

91. The Directors note without enthusiasm that by one view the reserve centers, particularly the United States, would not be required to settle holdings accumulated in the past, while a second view questions any asset settlement arrangement on the bases of technical difficulties, ability of reserve centers to undertake such arrangements, and the lack of a precedent for such a scheme. *Id.* at 24.

92. Due to the uncertainties of timing and magnitude involved in these factors, the Directors suggest the possibility of moving toward full asset settlement in phases. "This would offer an earlier contribution to the objectives . . . than if the transition from the present situation to full asset settlement were to be delayed until it could be made in one jump—but the contribution would . . . only be partial." Such phases, the Report states, might involve proportioned settlement of the U.S. deficits, or settlement up to a specified amount. *Id.* at 26.

arrangement according to its ability to achieve full asset settlement and its consideration of member-nations' preferences in asset composition.[93]

a. Total balance conversion

The first asset settlement arrangement proposed would require reserve centers to convert an amount equivalent to any net increases in the balances of its currency held by other nations. For example, if dollar balances held by member-nations totaled $10 billion when this arrangement went into effect, any net increase above this limit would have to be converted by the United States through its reserve assets. If the total balances of official holdings rose to $11 billion, the United States would be required to use its reserve assets of gold, SDR's, drawing rights, or foreign currencies to convert one billion dollars. The nations which would have to accept these United States reserves in return for their dollars, and the amounts they would have to accept, would be determined by the IMF through a procedure analogous to the present SDR designation method.[94] If the reserve center were in surplus, the net amount of its outstanding currency having decreased from $10 billion to $9 billion because member-nations had used their dollar holdings to purchase exports from the United States, the $1 billion which flowed into the United States would, in turn, be used to purchase SDR's from a special facility created by the IMF for such a purpose. These excess SDR's would then be used to convert additional dollars held by member-nations as reserves, thus further decreasing the amount of dollars outstanding to $8 billion. This second influx of dollars to the United States could not be converted into SDR's because the facility would be empowered to sell SDR's to reserve centers only in an amount equivalent to the original net decrease of the official holdings of their currencies by member-nations.[95] If the reserve center surplus is manifested by an inflow of currency other than that of the

93. "[I]n a situation in which countries continue to hold substantial amounts of currencies in their reserves, it would be necessary to consider how far account could be taken of differences of preference in asset composition. These differences to some extent reflect institutional factors, but they also reflect the concern that some countries would feel at any loss of any income entailed in holding reserves in the form of SDR's instead of reserve currencies, the differing degrees of confidence felt in different assets, and the desire to maintain flexibility and spread risks." *Id.* at 26.

94. *See* notes 40 & 41 *supra* and accompanying text.

95. "The objective that reserve centers should earn reserve assets when in surplus would be realized in part by channeling to these centers any SDR's that other countries wanted to use, *e.g.*, by the SDR designation mechanism." *Report on Reform, supra* note 7, at 27.

reserve center, this foreign exchange would be used for direct conversion without recourse to an SDR facility.

This approach would eventually lead to full asset settlement. It would accommodate the individual preferences of member-nations for a specific composition of their reserve assets, however, only to the extent that this could be done through the designation mechanism.

b. Individual net balance conversion

Under the second proposal for asset settlement, member-nations would agree not to let their total holdings of each reserve currency diverge from a previously specified level. Any holdings of a reserve currency above this level would be presented to reserve centers, which would be required to convert them with their own reserve assets of gold, SDR's or currencies other than their own. If holdings fell below the specified level, countries would reconstitute their balances by purchasing the reserve currency from the reserve center with their own currency or reserve assets.

A variation of this approach would specify only an upper limit, and ". . . rely on a substitution facility similar to that described [*supra*, subpara. (a) and *infra* subpara. (c)] to ensure asset financing of reserve center surpluses."[96] Full asset settlement would be accomplished according to the original amount of the reserve center currency to be left outstanding as originally agreed upon. Different asset preferences, however, could be accommodated only insofar as member-nations were able to specify their own amounts of reserve center currency holdings at the outset, unless the original levels agreed upon by each member could be modified at a later date.

c. IMF conversion

The third approach would achieve asset settlement directly through the IMF. A reserve substitution facility similar to that mentioned above would be established to create and sell SDR's. Member-nations with holdings of reserve currencies would be able to present them to the facility at any time in return for SDR's. If a reserve center were in deficit it could, but would not be required to, convert its currency by buying from the facility, in exchange for its reserves of gold, SDR's, or other currencies, an amount of its currency equivalent to the net increase in its liabilities

96. *Id.*

outstanding. Thus conversion would take place directly through the IMF. Nations whose holdings of reserve center currencies increase will presumably sell the net increase to the IMF in return for SDR's. This amount of reserve center currency would then be converted by the IMF through repurchase by the reserve center country. This method relies heavily on a reserve center's desire to decrease its liabilities even when in deficit, as the entire arrangement is voluntary. It is the most flexible method, however, permitting member-nations to maintain reserve center currencies as long as they desire and in any amount they prefer, while at the same time not requiring reserve centers to convert while in deficit. In this way, should member-nations lose confidence in a particular reserve center currency, the entire amount outstanding could be converted at the existing rate of exchange for SDR's without fear of depleting the reserve center's assets or of devaluation. When reserve centers were in surplus, however, asset settlement would proceed through the IMF facility as earlier described.

Although the Directors express no preference for any of these three proposals, it is noteworthy that these are the only methods presented and that each calls for a greatly expanded role of SDR's.

C. The Roles of Various Assets in Reserves

1. The Role of Reserve Center Currencies.

The major source of reserve creation today is through the accumulation of reserve center currencies, particularly the United States dollar.[97] If an asset settlement arrangement were adopted, then this method of reserve creation would be lost. In any of the three proposed methods for accomplishing asset settlement, the relative role of currencies would decline over time. This role would be taken over by SDR's; each method of asset settlement required as a minimum the creation of a reserve substitution facility empowered to create and sell reserve assets.[98] The extent of recourse available to member-nations to such a facility would depend upon the method

97. *See* note 43 *supra*.

98. "The necessary qualities of the reserve asset that would be needed for this purpose would be effectively the same as those of the SDR, and it would thus appear natural to use SDR's. . . . The substitution of newly created SDR's for reserve currency holdings . . . would require the establishment of a supplementary facility in the Fund." This facility the Directors label, for present purposes, the "Substitution account." *Report on Reform*, *supra* note 7, at 31-32. Plans for an expanded use of SDR's are by no means new, and encompass a larger area than that dealt with here. *See, e.g.*, Barattieri, *An Expanded Role for SDR's*, 4 EUROMONEY 12 (Mar. 1972); Fleming. *The SDR: Some Problems and Possibilities*, 18 IMF STAFF PAPERS 25 (1972).

of asset settlement adopted.[99] The operations of the substitution facility, however, would follow the general guidelines described in the methods of asset settlement.[100] For example, reserve centers could sell, in return for SDR's, an amount of their own currency equal to any decline in their outstanding liabilities. Nations holding reserve center currencies might also be entitled to sell their currency holdings for SDR's through the facility. The Report also points out that the substitution account might be adopted to permit countries to acquire reserve currencies in exchange for SDR's.[101]

There are, however, several objections to the establishment of a substitution facility empowered to create, buy and sell SDR's. Under two of the proposed methods, for example, recourse to the facility would be enjoyed mainly by reserve center nations. Non-reserve center nations might complain that this unduly favored reserve centers at their expense by replacing highly liquid reserve center currencies with less liquid SDR's, while returning the currencies to the hands of reserve centers for further use.[102] For example, non-reserve centers would be deprived of the use of surplus dollars as a means of intervention in the exchange market, but the United States would theoretically still be able to use dollars to finance its deficits. On the other hand, reserve centers might complain that under the third proposal voluntary exchange by non-reserve centers through the facility might result either in no change in their outstanding liabilities if non-reserve centers continued to hold reserve currencies, or, conversely, in a vast increase in the acceptance obligations of reserve centers, which is simply another form of liability.[103] Further, the Report points out such

99. Recall that the first and second methods proposed envisioned use of the substitution facility by reserve centers only, and in certain amounts; the third method envisioned voluntary recourse for all member-nations, particularly non-reserve centers, for exchange of unspecified balances of reserve currencies into SDR's.

100. *See* notes 91-96 *supra* and accompanying text.

101. "It might be convenient . . . for the account to be able to operate in both directions, *i.e.*, buying as well as selling SDR's in exchange for currencies. It could, to a large extent, take the place of the designation mechanism. . . ." *Report on Reform, supra* note 7, at 32.

102. "By 'international liquidity' is meant the aggregate stock of assets held by the national monetary authority that is unconditionally available to settle the country's imbalance in international transactions. At present, these international reserve assets consist of monetary gold, official foreign exchange holdings (mainly the U.S. dollar and pound sterling as reserve currencies), a member country's unconditional drawing rights at the IMF, and . . . Special Drawing Rights." Meier, *supra* note 1, at 248. SDR's are to be used only for transactions with participants to obtain currency (Art. XXV); no authorization is granted for use as direct payment of loans, for grants, or other like transactions. SDR liquidity is thereby hampered to some degree.

103. The SDR acceptance obligation is the requirement that a participating member-

an expansion of SDR's might put a strain on their present transferability and acceptability.[104]

2. An Expanded Role for SDR's

The proposed use of SDR's as a main reserve instrument rather than as a marginal supplement to other reserve assets requires, as the Directors recognize, a reconsideration of "... certain features of the SDR system in the context of reform, in particular those bearing on the use and acceptance of the SDR and on its relative attraction as a reserve asset."[105] The Report lists several factors which would have a direct bearing on the expanded use and attractiveness of SDR's.

a. The acceptance obligation

Under the present system, each participant in the SDR plan, if designated by the IMF, is required to accept SDR's from other participants if the acceptance of SDR's will not increase the transferee's total holdings above 300 per cent of its net cumulative allocation.[106] Modification of this obligation, as proposed in the Report, would generally increase the amount of SDR's which must be accepted by a participating member-nation. Three methods of modification are suggested by the Report:[107]

(i) The ratio of acceptance obligations to net cumulative allocations (*i.e.*, the 300 per cent requirement) could be increased to accommodate SDR's which nations held through transactions with the substitution facility rather than just those allocated to participants by the IMF. For example, if the allocation of SDR's to Italy were $50 million, Italy's present acceptance obligation is $150 million. If Italy acquired additional SDR's through the substitution facility in the amount of $10 million, by this proposal, the acceptance obligation would increase to $180 million.

(ii) The necessary acceptance obligations could be distributed among

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nation, designated by the Fund, supply the requested currency to the drawing nation. While SDR's are assets, the obligation to accept SDR's is a liability. The maximum amount of the liability is 300 per cent of a nation's net cumulative allocation. *See* note 39 *supra* and accompanying text.

104. "In this connection, it has to be borne in mind that any replacement of currency holdings by SDR's created for the purpose could require an assumption of additional acceptance obligations. The contribution of these . . . would cause problems if, as a result of the increased holding of SDR's in members' reserves, SDR's became a less favored asset." *Report on Reform, supra* note 7, at 34.

105. *Id.* at 37.

106. IMF Articles, *supra* note 2, Art. XXV, § 4; *see also* note 39 *supra*.

107. *Report on Reform, supra* note 7, at 38.

participants on the basis of some criteria other than net cumulative allocations, such as subscription quotas.[108] For example, if the ratio of acceptance obligations referred to the subscription quota of Italy, say, $100 million, Italy's acceptance obligation would be $300 million if the ratio remained at 300 per cent.

(iii) Acceptance obligations could be completely abolished. When the SDR has become established as the major reserve asset and its general acceptance is assured by its use as the principal medium for official settlement, exclusive reliance could be placed on the designation mechanism to distribute SDR's among participating member-nations.

b. The substitution facility

The second major factor in the use and acceptance of SDR's involves a lesser reliance on the delegation mechanism.[109] The necessary degree of reliance must depend, to a large extent, upon the final structure of the substitution account. However, the more transactions a substitution facility were to take part in, the less need there would be for designation; nations unable to find a willing participant in SDR transactions could go directly to the substitution facility rather than waiting for a participant to be designated.

c. Satisfaction of IMF obligations

The increased role of SDR's envisions a diminishing role for reserve currencies. At the present time, however, IMF repurchase obligations and subscription quotas cannot be satisfied by SDR's, but only by foreign exchange or gold.[110] The increased use and importance of SDR's might thus necessitate a review of these requirements to permit satisfaction of IMF obligations through SDR's.

d. Transactions outside the IMF

The use and attractiveness of SDR's might also be enhanced by permitting member-nations to use them for loans or grants to less developed nations, or for payment of debts between member-nations. Such transactions are not permitted under the present IMF Articles,[111] but amend-

108. *See* note 24 *supra* and accompanying text.
109. *See* notes 40 & 41 *supra* and accompanying text.
110. IMF Articles, *supra* note 2, Art. III, § 3(b), (c); Art. V, § 7 (b); *see also* note 24 *supra* and accompanying text.
111. IMF Articles, *supra* note 2, Art. XXV.

ment of the Articles to include such transactions will truly give SDR's the aspect of an international currency.

e. Interest rate on SDR's[112]

The present interest rate of one and one-half per cent per annum is considerably below the interest rate which can be earned on holdings of reserve currencies such as dollars.[113] A higher rate of interest would, therefore, have a direct bearing on the attractiveness of SDR's compared with other reserve currencies.

3. SDR's and Reserve Creation

At this point it is worth noting that although the Directors speak of providing ". . . for needed increases in reserves through the SDR mechanism,"[114] the Report refers to the powers of the substitution facility to create, sell or buy SDR's as limited to the net decrease of reserve center liabilities, or net increases in other members' holdings of reserve currencies. It provides, that is, only for asset settlement, which is simply a form of reserve substitution and not for reserve creation. Presumably, members will, in a reformed system under IMF control, necessarily look to the Board of Governors to provide for increases in world-wide reserves through the existing framework.[115] If one of the better points of reserve center currencies today is their ability to provide for world-wide increases in reserves, inflationary though this may be in some cases, a reformed system which provides for a decreasing use of reserve center currencies must also fill the gaps left behind.

Possibly, the Directors have in mind an eventual liberalization of the present restrictive mechanism for SDR creation.[116] If, for example, the

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112. IMF Articles, *supra* note 2, Art. XXVI, § 3. In the present system, "[t]he owner of gold has no right to interest by virtue of holding gold, but the holder of special drawing rights receives interest on them. The Fund pays interest, in special drawing rights, to all holders at the same rate on their holdings of special drawing rights. Participants pay charges, at the same rate as the rate of interest, on the net cumulative allocation of special drawing rights to them. . . . It is obvious that a participant holding more units than were allocated to it will receive a net amount of interest, and that a participant holding fewer units than were allocated to it will pay a net amount of charges." Gold, *supra* note 39, at 342.

113. IMF Articles, *supra* note 2, Art. XXVI, § 3.

114. IMF Articles, *supra* note 2, Art. XXIV, § 4. This Article reserves the powers of allocation and cancellation of SDR's to the Board of Governors; Article XXVII forbids delegation of these powers.

115. IMF Articles, *supra* note 2, Arts. XXI to XXXII.

116. The Directors also suggest a "broader and freer use" of SDR's. *Report on Re-*

reconstitution obligations were cancelled, SDR creation might be more equivalent to reserve creation. In addition, less stringent voting requirements might be considered in order to make SDR creation more flexible.[117]

Another solution to which the Directors might be looking is the automatic creation of reserves through the SDR interest rate, by which a nation would receive an annual percentage increase of its SDR holdings, and without the corresponding charges placed on SDR holdings.[118] Such a plan, however, does not allow for direct control over reserve creation except insofar as the IMF had control over increasing or decreasing the SDR interest rate. Further, this plan may unduly favor the strong industrial nations over the developing countries, as the latter are more likely to have to use their SDR's while the former can accumulate them, thereby depriving the most needy nations of the benefits of increased reserves.

4. The Role of Gold

The stress in the Report on a greatly increased role for SDR's in any reformed international monetary system is indicative of the tendency on the part of the Directors to seek the displacement of reserve currencies, such as the United States dollar, as major reserve assets, and their replacement with an internationally-controlled and supervised standard. The need to remove the fluctuating influences of reserve currencies from the system and put all nations on an equal footing has become obvious. The Report's attitude toward the role of gold as a reserve in a reformed system, however, is more cautious. The attitude of the Directors appears to be that gold, although constituting nearly a third of international reserves at the end of 1971, is likely to become relatively less important to the international monetary system in the future due to the expanding role of SDR's and other reserve assets which are more liquid and can draw interest. However, positive action with reference to the elimination of gold as a reserve asset is viewed by the Directors as inconsequential at best, and somewhat dangerous at worst.[119]

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form, *supra* note 7, at 39. "The present [SDR] mechanism is so complex that few have really mastered all its intricacies." Barattieri, *supra* note 98, at 12.

117. IMF Articles, *supra* note 2, Art. XXIV, § 4(d); this Article requires a majority of 85 per cent of the total voting power of the Board of Governors to approve SDR allocations.

118. *See* note 112 *supra*.

119. "In the Articles, the value of a special drawing right is stated to be 0.888671 gram of fine gold, with intentionally no provision for a change in the equivalence.

The Directors thus appear to favor a policy of patience and caution in dealing with gold as a reserve asset in a reformed international monetary system, and put their major emphasis on an expanded use of SDR's.[120]

III. RECENT REFORM DEVELOPMENTS

Concrete proposals for the reform of the international monetary system have recently been offered at the 1972 annual meeting of the International Monetary Fund in Washington, D.C.[121] On September 26, 1972, Secretary of the Treasury George P. Schultz, speaking on behalf of the United States, presented proposals ". . . with far more detail than the United States had offered before. . . ."[122] Referring to the Report of the Executive Directors,[123] and citing both the Smithsonian Agreements[124] and other public and private sources, Secretary Schultz noted ". . . certain principles underlying monetary reform [which] already command widespread support."[125] Within the framework of these principles, Secretary Schultz proposed a more flexible international monetary system stressing a maximum

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As a result, par values are *de facto* as firmly linked to SDR's as they are to gold and any change in the value of gold in terms of currencies involves automatically a corresponding change in the value of the SDR in terms of currencies. Thus, a change in the Articles which made the SDR the standard of par values—and which consequently defined the value of gold in terms of SDR's rather than that of SDR's in terms of gold—would derive importance only from its presentational effects, unless it were accompanied by some loosening in the link between the two. The desirability of such a loosening may, however, be questioned since it might add a new dimension of uncertainty to the relative values of different reserve assets." *Report on Reform, supra* note 2, at 34.

120. The Directors presumably view the future of gold in rather unfavorable terms. *Id.* at 35.

121. N.Y. Times, Sept. 27, 1972, at 1, col. 8.

122. *Id.*

123. In the words of Secretary Schultz: "As we enter into negotiations . . . , we have before us the useful report of the executive directors, identifying and clarifying some of the basic issues which need to be resolved." *Id.* at 70, col. 2.

124. *See* note 71 *supra.*

125. N.Y. Times, *supra* note 121, at 70, col. 3.

"First is our mutual interest in encouraging freer trade in goods and services and the flow of capital to the places where it can contribute most to economic growth. We must avoid a breakup of the world into antagonistic blocs. We must not seek a refuge from our problems behind walls of protectionism.

* * *

"A second fundamental is the need to develop a common code of conduct to protect and strengthen the fabric of a free and open international economic order.

* * *

"Third, in shaping these rules we must recognize the need for clear disciplines and standards of behavior to guide the international adjustment process—a crucial gap in the Bretton Woods system.

* * *

"Fourth, . . . we can and should leave considerable flexibility to national governments in their choice among adjustment instruments." *Id.* at 70, cols. 3, 4.

amount of individual freedom for member-nations in choosing adjustment policies to suit their needs and based upon a stronger role for the IMF.[126]

A. Exchange Rates

The proposals of the United States are based upon the assumption that even in a reformed system most nations will resire to maintain a stable par-value for their currencies, with the concomitant need for currency convertibility. Within the system of fixed exchange rates, however, the United States has proposed increased flexibility through the adoption of several plans.

1. Wider Margins

The United States proposals view as essential to the future of a reformed monetary system the establishment of wider margins around par-value which will be sufficient to ". . . dampen incentives for short-term capital movements, and, when changes in [par-] values are desirable, to ease the transition."[127] As the United States has based its proposals partly upon the Smithsonian Agreements,[128] the size of the margins proposed will presumably be those of the Agreements. The Agreements allow for a margin of 2.25 per cent on either side of par-value. Thus the par-value of the dollar may be expressed as "plus or minus 2.25 per cent of $38.00 equals one ounce of gold." Because other currencies are pegged to the par-value of the dollar, however, foreign currencies are thereby permitted a margin of 4.5 per cent on either side of par-value in terms of dollars, or a total margin of 9 per cent, while the total margin for the dollar is only 4.5 per cent. It is unclear whether the newly-proposed margins would be 4.5 per cent or 9 per cent, but it is clear that the United States will require that the total margins for the dollar be the same as that for all other currencies.[129]

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126. "These suggestions are designed to provide stability without rigidity. . . . We would strengthen the voice of the international community operating through the IMF." *Id.* at 70, col. 3.

127. *Id.* at 70, col. 5.

128. *See* note 71 *supra*.

129. "Building on the [Smithsonian] approach in the context of a symmetrical system, the permissible outer limits of these margins of fluctuation for all currencies—including the dollar—might be set in the same range as now permitted for nondollar currencies trading against each other. N.Y. Times, *supra* note 121, at 70, col. 5.

2. Optional Margins

In much the same way suggested by the Executive Directors,[130] the United States plans foresee margins of different sizes to suit the needs and interests of specific member-nations. Thus, countries in the process of forming a monetary union may prefer narrower margins among themselves, and would be allowed to set them accordingly. Developing nations which would prefer narrower margins for development purposes would also be accorded this option.

The United States plan also envisions circumstances in which countries may wish to "float" their currencies. This would also be permitted within the authority of the IMF, but with the caveat that they ". . . should be required to observe more stringent standards of behavior in other respects to assure the consistency of [their] actions with the basic requirements of a cooperative order."[131]

B. Balance of Payments Adjustment

1. Adjustment through Exchange Rates

The proposals made by the United States recognize the vital role which the adjustment mechanism plays in the success of the international monetary system,[132] and, like the Report of the Executive Directors, envision the employment of objective criteria to determine the timing and size of the adjustment of a nation's exchange rate. The United States, however, proposes that the major criterion be ". . . disproportionate gains or losses in reserves. . . ."[133] for a nation. A disproportionate gain would indicate a nation in surplus and call for revaluation of that currency in order to reduce the surplus. A disproportionate loss of reserves, on the other hand, would indicate a nation in deficit, and call for devaluation of the cur-

130. *See* notes 71-74 *supra* and accompanying text.

131. N.Y. Times, *supra* note 121, at 70, col. 5.

132. "In a system of convertibility and central values, an effective balance-of-payments adjustment process is inextricably linked to appropriate criteria for changes in central values and the appropriate level, trend, and distribution of reserves. Agreement on these matters, and on other elements of an effective and timely adjustment process, is essential to make a system both practical and durable." *Id.* at 70, cols. 5-6.

133. "[T]he most promising approach would be to insure that a surfeit of reserves indicates, and produces pressure for, adjustment on the surplus side, as losses of reserves already do for the deficit side. Supplementary guides and several technical approaches may be feasible and should be examined. Important transitional difficulties will need to be overcome. But, in essence, . . . disproportionate gains or losses in reserves may be the most equitable and effective single indicator we have to guide the adjustment process." *Id.* at 70, col. 6.

rency. The underlying principle of such an approach is that surplus nations have as much obligation to take action to adjust their payments imbalances by exchange rate adjustment as do deficit nations.[134] This principle, however, is ". . . far from universally accepted abroad . . . ."[135] and will constitute a major difficulty in negotiations.

2. *Other Methods of Adjustment*

Large revaluations or devaluations are not the only methods of adjustment supported by the United States. A nation would be free to make small changes in its exchange rates on its own initiative in an attempt to adjust imbalances, although no indication of the limits of a "small" change is offered. Were the imbalances to continue with a disproportionate gain or loss of reserves, a nation would build a ". . . prima facie case for a larger devaluation. . . ."[136] to be made at some point ". . . [u]nder appropriate international surveillance."[137]

The United States plan offers further options for adjustment in lieu of a change in the exchange rate. The first option encourages nations, where appropriate, to engage in strict internal monetary and fiscal discipline to adjust imbalances, and second, ". . . in exceptional circumstances and for a limited period. . . ."[138] a nation may be permitted to impose direct restraints on trade as long as they are general and nondiscriminatory.

3. *International Monetary Discipline*

Under the United States plan, the role for the IMF would presumably be restricted to approval of large changes in par-value, as it is now.[139] The optional methods of adjustment would be at the member-nation's discretion, and even a large alteration of par-value would still be initiated by the nation concerned, and not by the IMF as the Directors had proposed.[140] The United States plan does, however, provide for some of the leverage the Directors viewed as necessary to urge needed changes for adjustment. Rather than grant to the IMF the power to initiate changes in a nation's exchange rate in order to force adjustment, the United States

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134. *Id.* at 71, col. 1.
135. *Id.*
136. *Id.* at 70, col. 6.
137. *Id.*
138. *Id.*
139. *See* note 27 *supra* and accompanying text.
140. *See* note 62 *supra* and accompanying text.

plan recommends the use of various sanctions, which would be imposed by the IMF. For example, a nation, facing a disproportionate decrease in its reserves, which failed to take the necessary adjustment measures, might be deprived of its drawing rights or SDR allocations, thereby depriving it of the sources of reserves necessary to finance its deficit.

A nation with a disproportionate increase in its reserves, however, which failed to make adjustment would be deprived of its right to demand conversion of the foreign currencies it had accumulated through its surplus, thereby depriving it of the benefits of its surplus. As a last resort, the United States recommends that, outside of the IMF framework, ". . . in the absence of a truly effective combination of corrective measures, other countries should ultimately be free to protect their interests by a surcharge on the imports from the chronic surplus country."[141] The surcharges would have the same effect as a revaluation of the surplus nation's currency *vis-à-vis* the surcharging nation.

C. Asset Settlement

While recognizing its obligation to convert official dollar holdings into other reserve assets, the United States has made it clear in its proposals that asset settlement can come into operation only after a transitional period.[142] The final decision to engage in a specific asset settlement arrangement, however, will rest upon the demonstrated capacity of the United States to meet its obligations by increasing its reserve position through a balance of payments surplus. Thus the United States has proposed that asset settlement be deferred until a future date when, after a transitional period during which the reformed adjustment mechanism may take effect through devaluation of the dollar or revaluation of other currencies, the United States will enjoy a surplus in its balance of payments. The resultant increase of United States reserves would ease the obligation of conversion of outstanding dollars, and lessen the official role the IMF would play in asset settlement arrangements.

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141. N.Y. Times, *supra* note 121, at 70, col. 6.

142. In the words of Secretary Schultz: "I am fully aware that the United States, as well as other countries, cannot leap into new monetary and trading arrangements without a transitional period. I can state, however, that after such transitional period the United States would be prepared to undertake an obligation to convert official foreign dollar holdings into other reserve assets as a part of a satisfactory system . . . assuring effective and equitable operation of the adjustment process. That decision will, of course, need to rest on our reaching a demonstrated capacity during the transitional period to meet the obligation in terms of our reserve and balance-of-payments position." *Id.* at 70, col. 8.

This position is in opposition to the Report of the Executive Directors, which views asset settlement arrangements as a necessary part of any present reform of the international monetary system.[143] The United States proposals indicate the possibility of compromise, however. The Plan notes that official foreign currency holdings need be neither generally banned nor encouraged. Furthermore, it notes that the maintenance of such holdings can provide a useful margin of flexibility in reserve management, and suggests ". . . careful study . . . be given to proposals for exchanging part of existing reserve-currency holdings into a *special issue* of SDR's, at the option of the holder."[144] Presumably, the third method of asset settlement proposed by the Executive Directors, which was voluntary and did not require reserve centers to engage in immediate conversion of their outstanding liabilities, would be acceptable to the United States. In this way member-nations could convert excess dollar holdings through the IMF, while the United States could refrain from settlement during a transitional period in an attempt to improve its reserve position.

It should also be noted, however, that the United States called for a "special issue" of SDR's to accommodate official holders of surplus dollars. A "special issue" of SDR's implies issuance through the existing SDR methods of allocation,[145] on a one-time-only basis. The Directors, however, have recommended a permanent "substitution facility" which would create SDR's for exchange of officially-held surplus dollars on a continuing basis.[146] This apparent conflict may prove to be a difficult point of negotiation in the near future.

D. Reserve Assets

The United States proposal contemplates an increased role for SDR's, in the sense that they would become the official "numeraire"[147] of the system. To facilitate this, the United States also proposes an end to the

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143. *See* notes 88 & 89 *supra* and accompanying text.
144. N.Y. Times, *supra* note 121, at 70, col. 5 (emphasis added).
145. *See* note 39 *supra* and accompanying text.
146. *See* notes 98-101 *supra* and accompanying text.
147. "Numeraire" is the term given to that asset in terms of which all others' assets are valued. In the present system, the numeraire is gold, all currencies and SDR's ultimately being valued according to their worth in gold. The United States proposal, if adopted, would value all currencies in terms of SDR's. This is not to say, however, that gold would no longer be a reserve asset: "I do not expect Governmental holdings of gold to disappear overnight. I do believe orderly procedures are available to facilitate a diminishing role of gold in international monetary affairs in the future." N.Y. Times, *supra* note 121, at 70, col. 5.

reconstitution obligation, designation procedures, and holding limits. Although the Executive Directors have implied that these encumbrances on SDR's might be removed, they are reluctant to replace gold with SDR's as the system's numeraire.[148]

The United States also proposes a method by which world reserves could be controlled through SDR's. This would involve a periodic review of changes in the amount of SDR's allocated in order to meet any increased need for reserves. The Executive Directors are, however, silent on this point.

IV
FUTURE DIRECTIONS OF REFORM

New trends in the thinking on international monetary policy are rapidly taking shape. The 1972 Report of the Executive Directors of the IMF has integrated these trends into a comprehensive study of the international monetary system, its flaws, and the direction of long-awaited reform. The three requirements of successful reform are: 1) an improvement in the exchange rate mechanism; 2) asset settlement; and 3) an enlarged role for Special Drawing Rights in place of gold and reserve currencies. The interrelationship of these three steps is such that the implementation of one impels adoption of the others; therefore, they must be employed in conjunction and cannot be instituted seriatum.

The final form of the exchange rate mechanism will include a substantial role for the IMF in the initiation of parity adjustments. It will likely contain a provision for wider margins around par, with a compromise option of maintaining narrow margins for those member-states, such as developing nations, which are likely to profit from the greater stability.[149]

A major aim of a reformed exchange mechanism will be to restore some measure of control and responsibility to reserve centers for their own exchange rates. To this end, a strong provision for achieving asset settlement will probably be included, with several recommendations for dealing with the sticky technical aspects of timing and method of implementation.

Intrinsic to any asset settlement arrangements is an expanded role for

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148. *See* note 121 *supra* and accompanying text.
149. An option, such as that offered by Article IV relating to methods of maintaining parity, may be employed to permit some individual choice of margins.

SDR's. This will be accomplished by the creation of a facility empowered to create, sell and buy SDR's and, perhaps, to exchange reserve currencies as well. Further suggestions go a long way towards transforming SDR's into an international currency, and include a freer use of SDR's, with an increase in acceptance obligation requirements, an increase in the special interest rate, and, concurrently, deemphasis, although not abandonment, of the present designation mechanism.

Future negotiations on monetary reform will focus on these lines. This is not to say, however, that final reform will precisely mirror the Report's proposals, for cooperation and compromise are of course the heart of any international agreement.[150] It is fairly certain, however, that the reformed system will reflect elements of a substantial number of the proposals made in the Report.

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150. ". . . [I]t must be recognized that however well any new arrangements are designed, their success cannot be ensured without the determined cooperation of members in a more effective functioning of the system as a whole." *Report on Reform, supra* note 2, at 10.